

Tajikistan's Economic Prospects and Challenges¹

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Like other countries in the region, Tajikistan has been affected by declining demand abroad. Recent estimates show that real GDP grew by around 2% in 2009 (compared to an estimated 7-8% in 2008 and an average of 8% in 2000-2008) as the demand for Tajikistan's principal exports (aluminum and cotton) fell and declining remittance inflows (the majority from the Russian Federation) affected domestic demand. Aluminum exports and remittances are important determinants of the health of the Tajik economy. Aluminum exports have made up 70-80% of total exports for a number of years and remittances were estimated at over 50% of GNP in 2008, when they played a large role in fueling demand in the construction and service sectors. Faster GDP growth is expected in 2010 (at 4-5%) as export volumes and remittance flows recover thanks to better regional economic health. Exports will also benefit from higher prices.

Several positive developments helped Tajikistan avoid a contraction in GDP. While remittance inflows fell by 50% year-on-year in the first half of 2009, their volumes were still large enough to help support domestic demand. In addition, grain production grew by 40% year-on-year in the first six months of 2009, and year-on-year production increases were also seen in potatoes (3%), vegetables (14%) and melons (56%). The favorable performance of agricultural products is attributable to good weather, better inputs (seeds and fertilizers) and a government-approved increase in the use of arable land for food crops. The agriculture sector's significance to the economy is characterized by its impact on GDP and employment: in 2008, agriculture accounted for 22.7% of GDP and employed approximately two-thirds of the labor force. Finally, foreign investments in large construction activities (such as the Sangtuda-1 hydroelectricity plant financed by the Russian Federation) continued throughout the year.

Tajikistan is the most remittance-dependent economy in the world and remittances are a crucial determinant of the performance of the Tajik economy. The dollar amounts brought into the Tajik economy through remittances amounted to over 50% of GNP in 2008. Such levels make a significant difference in Tajikistan's external balance² and are an important source of foreign reserves. Remittances to Tajikistan also help sustain demand and fuel the economy through their positive impact on household incomes because they represent at least a third of total income in households with members working abroad. This income impact also pulls many households above the poverty line. However, such reliance makes Tajikistan extremely vulnerable to adverse

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² Remittances are recorded in the current account.

changes in the demand for foreign workers abroad. Remittances fuel a Tajik economy that has not yet reached the capacity to absorb more of its workers. While gaining this capacity may be desirable, such transition seems unlikely in the near future.

Poverty rates have fallen since the late 1990s thanks to economic growth and high remittances volumes, but Tajikistan remains the poorest country in the Commonwealth of Independent States. The last household survey conducted in 2007 estimated that 53% of the population lived under \$4.22/day and 17% lived under \$2.70/day (both in PPP terms). The vast majority of the poor (70%) live in mountainous and rural areas. Inequality is high and the Gini coefficient, a measure of income inequality (range is from 0 = perfect equality to 1 = perfect inequality), stands at 0.51. Health, water and sanitation services are generally either lacking or of poor quality. Health and education indicators have worsened over the years despite increased public investment. Additionally, while there is disagreement over whether unemployment or low-productivity employment contributes to poverty, it is agreed that most workers are hampered by low levels of skills and education.

Although no data are available on current poverty rates, these are estimated to have risen in 2009. Slower economic activity in the Russian Federation (whose GDP is estimated to have contracted by 7% in 2009) significantly affected poverty rates, since the vast majority of migrant laborers worked there before the crisis. In 2008 half of the potential Tajik labor force was employed abroad and the share of remittance income in total household incomes ranged from 30% to 70%, with a higher dependence in poor and rural areas. The Ministry of Labor and Social Protection estimated that during the first quarter of 2009 alone, around 10% of the workers who had been employed in Russia returned to Tajikistan.

The current crisis has probably increased the vulnerability faced by many poor Tajiks since the harsh 2007/2008 winter, when productive assets were sold and additional debt was incurred. In September 2009, the IMF estimated that even a 5% growth rate in 2010 would not be fast enough to make a significant dent in poverty, and that the total reduction in per capita disposable income caused by the crisis in 2009 could reach 20% in 2009.

The current account will post small surpluses in 2010-2011 and remittance inflows will continue to have a significant influence on the external balance. The current account deficit was equivalent to an estimated 8-9% GDP in 2008 as import volumes were large and international food and energy prices were high during the first half of the year. The trade deficit narrowed significantly in 2009 due to a sharp reduction in imports. Nonetheless, estimates in October and November 2009 put the 2009 current account

deficit at 8-10% of GDP, reflecting the sharp drop in remittance inflows caused by the global downturn. In 2010 and 2011 the current account deficit is forecast to narrow to 0.2 and 1.1% of GDP respectively. Although imports are projected to increase in nominal and real terms, the trade deficit will be offset by the resumption of remittance inflows. Tajikistan's currency (the somoni), having strongly depreciated in 2009, is projected to slowly regain value in 2010 if remittance inflows recover as anticipated and as the U.S. dollar depreciates.

Prices are estimated to have risen by 6.7% in 2009 and are expected to rise further by 7.8% in 2010 and 8.3% in 2011. Because Tajikistan imports much of its food, fuel and raw materials for construction work on infrastructure, the projected rise in the global prices of energy, food and raw materials will generate inflation. Similarly, the resumption of economic activity in the region and the corollary increase in remittance inflows will cause domestic demand to rise and prices to increase. In addition to these factors, the potential occurrence of adverse weather conditions poses an inflationary risk because of their disruptive impacts on supply.

Tajikistan's financial sector is largely undeveloped, limiting the impact of interventions by the central bank. The central bank cut the refinancing rate eight times in 2008-2009. The four cuts in 2009 reduced the rate from 13.5% to 8%. The undeveloped nature of the financial system as well as weak institutional capacity is expected to constrain the effectiveness of monetary policy into 2010-2011, although limited reforms in the banking sector are expected to increase efficiency and investor confidence to a certain extent.

Although international financial linkages are weak, the banking sector is threatened by potential non-performing loans in the cotton sector. Debt in the cotton sector was estimated at \$553 million in 2008, when it represented 22% of total bank debt. The agriculture sector, in which cotton is the most produced commodity, suffers from competition problems, lack of productivity and efficiency, and slow structural reforms. However, in mid-2009, the government in concert with donors created six working groups to formulate recommendations on reforms in the sector, including in agricultural finance, land (including land administration), water, and rural development.

Small businesses employ a third of the working population, but they are burdened by a difficult business environment. The small and medium enterprise sector represents approximately one-third of employment, including one-half in the agriculture sector, according to a 2006 estimate by the IFC. Tajikistan's business environment is characterized by administrative inefficiencies, insecure property rights, an unpredictable commercial law system, scarce access to finance and a dearth of skilled workers. The

World Bank's *Doing Business* report 2010 ranked Tajikistan 152nd out of all 183 countries ranked in the report. However, between June 2008 and June 2009, five business indicators (starting a business, dealing with construction permits, getting credit, protecting investors, and closing a business) registered positive changes.

Poor infrastructure continues to be a barrier to commercial activity. The state of the power sector, for example, is expected to slow down industrial activity by causing blackouts during the winter of 2009-2010. Communications, energy, transport, and water supply infrastructure was damaged by Tajikistan's civil war (1992-97) and natural disasters, as well as unfortunate management and a lack of resources. However, financing from China, Iran, Kazakhstan and the Russian Federation, encouraged and actively sought by the Tajik government, has increased in recent years although the government is still looking for investors to develop its largest hydropower project (the Roghun hydroelectric plant).

The budget remains in surplus, but many expenses are financed by donors. The state budget posted a surplus amounting to 1-2% GDP in 2008. This excluded donor financing under the public investment program (PIP), which allows the government to obtain loans under concessional terms. Including the PIP, the fiscal deficit amounted to 5.5% of GDP in 2008 and 2009. Excluding the PIP, the government is expected to post a surplus averaging 0.7% of GDP in 2010-2011 thanks to higher revenues expected from the resumption of economic activity, especially the improved performance of the cotton and aluminum sectors. In June 2009, the government obtained a US\$120m loan from the IMF under a three-year poverty reduction and growth facility (PRGF). The 2010 budget, which projects a 27% revenue increase in 2010 over 2009, was approved by the council of representatives in November 2009. The principal spending priorities are social security, education, the continuation of the construction of the Roghun hydroelectric plant, and defense and security.

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